

No. 22444

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

DANIEL H. DEUTSCH, EVELYN M. DEUTSCH, ALFRED
DEUTSCH, BERNICE DEUTSCH, WILLIAM DRELL,
ETHEL DRELL,

Appellants,
vs.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

APPELLANTS' OPENING BRIEF.

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FILED

MAY 31 1968

WM. B. LUCK CLERK



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I.

The Court Should Have Determined That the Intent of the Parties, as Proven by Subsequent Performance of All Parties, Was That the Contract of January 3, 1959, Was Controlling as to the Basis of the Stock in the Hands of the Appellants. There Was an Offer, an Acceptance, and Later Performance. The Court Should Have Recognized That All Parties at Time of Contract Recognized the Fact That Delivery of Certificates Would Be Restrained for One Year and a Condition Subsequent Was Imposed That in the Event of Non-Delivery in Five Years, That the Petitioners Could Revert to Their Then Status in Regards a Claim for Accrued Salaries

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APPELLANTS' OPENING BRIEF.

Statement of the Pleadings.

The three docketed cases have been consolidated because the same facts and legal issues are controlling in each case for the years involved.

The only question is whether the stock received by the Appellants for accrued salaries is to have a basis of \$1.00 per share, as per contract of January 3, 1959, by and between the Corporation and Appellants, or is it to have a basis of \$8.00 per share as per the fair market value of the certificates at time of receipt by Appellants May 5, 1960. Appellants file on a calendar year basis.

Daniel H. and Evelyn M. Deutsch.

The Commissioner charged that the stock received by Appellants should have a basis of \$8.00 per share as cost basis, rather than \$1.00 per share as reported and

assessed a deficiency for the year of 1960 in the sum of \$45,016.13, and then per said audit allowed an overassessment for the year of 1961 in the sum of \$5,-836.78.

William and Ethel Drell.

The Commissioner charged that the stock received by Appellants should have a basis of \$8.00 per share as Cost Basis rather than the \$1.00 per share as reported and assessed a deficiency for 1960 in the sum of \$28,-695.09 and then per said audit allowed an overassessment for the year of 1961 in the sum of \$5,294.00.

Alfred and Bernice Deutsch.

The Conimissioner charged that the stock received by Appellants should have a basis of \$8.00 per share as Cost Basis rather than the \$1.00 per share as reported and assessed a deficiency for 1960 in the sum of \$23,-046.13 and per said audit allowed an overassessment for the year of 1961 in the um of \$5,551.46.

By amendment to their answer the Respondents in the alternative claimed an increased deficiency of \$24,-416.05 for the calendar year of 1960 due to Alfred's receipt of the shares, as trustee, to be delivered to Malin.

The issue for decision is whether each group of Appellants realized income in the calendar year 1960 in the amount of the fair market value of each share at \$8.00 per share, or conversely, did each group of appellants constructively receive or actually become the owners of said stock in 1959 by reason of their contract with the Corporation under date of January 3, 1959. The Appellants do not contest the fact that the shares should have been reported in 1959 rather than 1960 at \$1.00 per share, but the tax effect is nil.

Trial of issue in Tax Court of Los Angeles, California, within appeal jurisdiction of United States Ninth Circuit Court of Appeals and judgment in accordance with above provisions rendered on August 21, 1967. Appeal filed by all Appellants for review and reversal of Tax Court's decision, pursuant to pertinent Federal Rules of Procedure.

Statement of the Facts.

All Appellants used the cash basis and reported on calendar year status. At time of filing, all returns were joint returns by the respective husbands and wives.

Alfred Deutsch, Daniel Deutsch and William Drell (hereinafter referred to by their given names) are chemists.

In 1952 they incorporated the Foundation for Biochemical Research as a non-profit corporation. The primary purpose of the Foundation was the preparation and distribution to scientists of biochemicals which were needed in research, but which were not commercially available. The three Appellants were respectively the Secretary-Treasurer, President and Vice President of the Foundation. They were also members of an eight-man Board of Trustees. The other Trustees were prominent or famous men in the field of biochemical research.

In 1958 the Board of Trustees decided that the Foundation should confine its activities to the field of biochemical research and divest itself from all commercial activity. Thus, in March of 1958, the California Corporation for Biochemical Research (hereinafter referred to as Corporation) was incorporated under the laws of California by Alfred, Daniel, and William.

Daniel was President, William was Vice-President, and Alfred was Secretary-Treasurer. During a period of time from 1958 through 1960, Bernard Malin was Treasurer. The Directors were Daniel, William, Alfred, and Bernard.

The Corporation was authorized to issue common stock at \$1.00 per share, and preferred stock at \$100.00 per share which was convertible to common stock, under certain conditions, at the ratio of one hundred shares of common stock for each share of preferred stock.

In March of 1958, the Corporation assumed the operation of the commercial aspects of the Foundation.

In September of 1958, an agreement was entered into between the Foundation and the Corporation whereby the Corporation would receive all the operating assets of the Foundation in exchange for 1920 shares of preferred stock and 116 shares of common stock of said Corporation. On October 24, 1958, both entities executed an "Agreement, Bill of Sale, and Assignment" to carry the September agreement into effect. The assets were valued at \$192,116.72. The agreement was subject to the approval of the California Corporation Commissioner and the Federal Securities and Exchange Commissioner.

On October 23, 1958, the Corporation Commissioner, by permit approved the transaction by required impoundment in escrow of the 1920 preferred shares and 116 common shares until release was authorized by the Corporation Commissioner. Union Bank was designated as Escrow Agent.

The Escrow Agreement provided for release upon approval, but in no event in *less than one year* from com-

mencement of public offering. Escrow began October 28, 1958. Restrictions compatible with Corporation Commissioner were imposed by Securities and Exchange Commission.

As of October, 1958, the Foundation owed the Appellants, as salaries for services rendered, the following amounts:

Daniel	\$9,267.00
Alfred	\$5,443.00
William	\$6,452.00
Total	<hr/> \$21,162.00

As of that date, the Appellants discussed with the Board of Trustees the proposition that they would take common stock in lieu of their back salaries at the then fair market value of \$1.00 per share. Appellants and Board of Trustees realized the restrictions imposed and that delivery of stock certificates would be delayed at least one year. The Board of Trustees met, discussed the transaction, and accepted the Appellants' offer. The fair market value of each share of common stock as of that date was \$1.00 per share. This is borne out by the fact that between October 27, 1958 and April 24, 1959 150,000 shares of common stock were sold to the public at \$1.00 per share.

Bernard Malin, attorney and Certified Public Accountant, had also rendered services to the Foundation and was owed fees amounting to \$10,000.00. Malin also wanted stock but his cash position would not allow a cash purchase. The Appellants, after discussion, agreed with Malin to sell him 25% of the stock they received at \$1.00 per share. They discouraged Malin

from attempting to have the Board of Trustees make a similar sale to him. They encouraged him to get cash. This agreement was immediately subsequent to their agreement of January 3, 1959. Upon receipt of the stock in 1960, they performed in good faith and sold Malin 25% of the stock at \$1.00 per share. In addition, they agreed to give Malin 5000 shares of promotional stock that each received (promotional stock not in issue).

The Memo of Agreement of January 3, 1959 (crux of this case) was drafted by Appellants without advice of counsel and reads as follows:

Memo of Agreement.

The undersigned officers hereby agree that they will not request cash payment in satisfaction of the back salaries now owing to them and standing on the books of the Foundation, but will accept in lieu of cash an equal amount of common stock of California Corporation for Biochemical Research as follows:

Alfred Deutsch	5443 shs. (sic)
Daniel Deutsch	9267 shs. (sic)
William Drell	6452 shs. (sic)

They further agree that these shares of stock be transferred to them in due course after the Foundation preferred stock had been released from escrow and converted to common shares, provided that such shares are transferred within five years of this date.

On January 11, 1960 the Corporation filed for release of stock which was approved by Corporation Commissioner on January 20, 1960. Shares were delivered to the Foundation, and by meeting of Board of Trustees

delivered to Appellants on April 7, 1960. Delivery effected May 5 and May 6, 1960. Subsequently 5290 shares were sold to Malin at \$1.00 per share.

At the time of issuance of Certificates the stock had a fair market value of \$8.00 per share.

The Appellants, through error, failed to report the stock at \$1.00 per share as income during 1959. They were unaware of the doctrine of constructive receipt although they did appreciate the fact that they were owners of the shares, pending issuance of the stock. They therefore, as officers of the Foundation, did not record the payment from the Foundation on the Foundation books until 1960. However, the Foundation recognized their right to receipt of the shares at \$1.00 per share and honored it. The Appellants recognized Malin's right to purchase 25% of the stock at \$1.00 per share and honored it. Even though the stock had increased in value, all parties recognized the right of ownership effective as of January 3, 1959.

Specification of Error.

The Court erred in determining that the agreement was not a transfer of a present interest in 1959, but were terms referring to a transfer of interest in the future. The Court ignored the fact that the transaction was a completed transaction, honored by all parties as a transfer of title in 1959. The Court, disregarding the basic equitable doctrine of "substance over form", used an interpretation of the agreement which the Court was aware was written by laymen, to reach a decision based on semantics, all parties recognized that the stock had *been set aside* for Appellants in 1959 and honored the segregation by delivery of certificates when available.

(Section 1.451-2(a), Income Tax Regulations)

The Court further erred in comparing this case with *La Motte T. Cohn*, 8 T.C. 796 (1947). In that case delivery of promotional stock was at issue. In this case the Appellants purchased the stock in 1959, relinquishing their right to accrued salaries as payment. They purchased said stock at the fair market value as of said date. In the event that the stock could never be released, by agreement as a *condition subsequent* could reestablish their claim to accrued salaries. It is interesting to note that in this "laymens'" document, no reference to the Statute of Limitations or waiver of same, is set forth.

The Court disregarded the law set forth in *Robbins v. Pacific Eastern Corporation*, 65 P. 2d 42 (Supp. Ct.—California 1937) that physical delivery of the certificates is not necessary to pass title to stock.

The Court paid no heed to the basic law of contracts that there had been an Offer and Acceptance in 1959 constituting a contract in which all parties as reasonable and prudent men and in recognition of the restrictions existent upon delivery over of certificates, had openly agreed and later performed. If dividends had been declared, they would have been held to the credit of the Appellants (*Estate of Arthur L. Hobson* (1951), 17 T.C. 854). The Court, in reliance on the restrictions, stated that the transfer was only an attempted transfer or a promise to transfer in the future. The Court failed to note that there actually can be a transfer of title by contract even though the purchaser would have the right of rescission of said contract on the basis that a violation of Corporation Codes had occurred. However, this would be a personal right and unless invoked would not bar passage of title. In the instant case, this right

was not invoked and title to the stock passed to Appellants in 1959.

The substance of a transaction in which a taxpayer engaged, rather than the form of the transaction, is controlling in determining income for purposes of taxation.

CIR v. Griffiths, C.C.A. 1939, 103 F. 2d 110;
Argo v. CIR, C.C.A. A1 1945, 150 F. 2d 67.

Taxation is an immensely practical matter and the substance of the thing done, and not the form it took, must govern, as regards liability for income tax.

Eastern Coal Corporation v. Yoke, DCW-Va.
1946, 66 F. Supp. 166.

It has been held in option situations that the employee received income when he received the option, rather than when he exercised it.

McNamara v. CIR, 210 F. 2d 505.

The shares of stock are the substance, not the certificates. That is merely the muniment of title or evidence of ownership, it is not the property in the real sense.

Kirkland v. Levin, 63 Cal. App. 589;
Jean v. Jean, 207 Cal. App. 115.

A person may own an interest in the capital stock of a corporation although the certificates are never issued to him.

Meyer & Heller v. Ramona Village, 5 Cal. App. 2d 679;

California So. Hotel v. Callendar, 94 Cal. 120.

In the instant case the Appellants by purchase of the stock in 1959 not only acquired the right to ownership and dividends, but also assumed the Risk of Loss in the

event of failure of the Corporation. Risk of Loss and Declination of Values follows ownership.

People v. Seymour, 54 Cal. App. 2d 527;

Capalain v. L.A. Wrecking, 37 Cal. App. 2d 527;

CIR v. Tying, 106 F. 2d 55 (C.A. 2—1939).

In *Lee v. Comm.*, 143 F. 2d 4 (C.A. 7—1944) the Court held that if the circumstances indicate that the parties intended an immediate sale, the transaction should be construed as a present sale even though seller retained legal title and possession of the property.

In *Balnovski v. Comm.*, 236 F. 2d 298 (C.A. 2—1956) the Court held that when title passes depends upon the intentions of the parties.

In the case of *Harold E. MacDonald v. Comm.*, 230 F. 2d 534, petitioner received a discounted option in 1948 for 10,000 shares. The stock was sold in 1949 when obtained through exercise of option. Commissioner took the position of income between discounted option price and sales proceeds in 1949, negating capital gains treatment. The Court said MacDonald had income in 1948 between the fair market value of the option and the price he paid for it. The holding period was at time of receipt of option and recognized the contract.

In the case at bar, the Appellants recognized the value at \$1.00 and sold 25% to Malin at said price. This was the fair market value at time of contracting. The Court properly held that the basis to Malin was \$1.00 under the doctrines set forth in

Phil Kalech, 23 T.C. 672;

Cooley, 23 T.C. 223;

Helvering & Savage, 297 U.S. 106.

The Court erred in quoting as comparison the case of *Fred C. Hall*, 15 T.C. 195, 194 F. 2d 538. In that case the certificates were issued, signed and returned to employer. The redelivery at certain dates were subject to satisfactory services being performed in the interim as a *condition precedent* to said redelivery. In this case, the services had been performed, the salaries accrued, and an actual purchase of the stock effected by Appellants by cancellation of claim for accrued salaries. The right to re-establish claim for salaries was a *condition subsequent* in the event of impossibility of delivery of certificates.

In *Heiner v. Gwynne*, 114 F. 2d 723 the Court held that a restriction on sale or possession of stock certificates does not necessarily, negate proof of its fair market value at time of contract even though it may limit the number of prospective purchasers. The equitable and beneficial interest is in the buyer even though he does not have physical possession of the certificate.

In *Comm. v. Timmer*, 78 F. 2d 599, some employees were to receive stock after reorganization of the corporation. This agreement was reached in 1920. The Corporation was never reorganized and they never received their stock. The employees sold their *equitable interest* to the majority stockholders in 1925. The Court held that the fair market value as of 1920 was the base for determining capital gains, it was not earned income when received in 1925.

In the present case the Court is in direct conflict by its attempt to divide the contract, its intent, purpose and performance. It recognizes the contract as to the 25% allocable to Malin but denies recognition for the 75% to Appellants. The cases cited above all establish

the facts that the fair market value of the stock is the basis at time of making of the contract as recognized by the parties involved. It is their intent that controls, as supported by the basic law of Contracts. In this case the Appellants were subject to approval of the contract by the Board of Trustees. All parties approved and performed that contract and the Appellants performed their contract which was incidental and collateral to their contract with the Foundation. What more definite proof can one present than agreement and performance by all persons concerned.

Taxation is necessary for preservation and operation of any nation. Taxation must be fair. Unfair taxation without representation was the very basis for establishment of this nation. To allow a taxing agency to engage in legalistic semantics to avoid recognition of a fair and equitable contractual relationship is unfair taxation.

Therefore, the Appellants contend that the contract of January 3, 1959 controls and that the fair market value of that date (\$1.00) is the proper Cost Basis of said stock.

The Appellants respectfully request this Honorable Court to reverse the Tax Court's decision as to the shares allocable to them and determine their cost at \$1.00 per share.

Respectfully submitted,

DERMOT R. LONG,

Attorney for Appellants.

Certificate.

I certify that in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit and that, in my opinion, the foregoing brief is in full compliance with those rules.

DERMOT R. LONG

